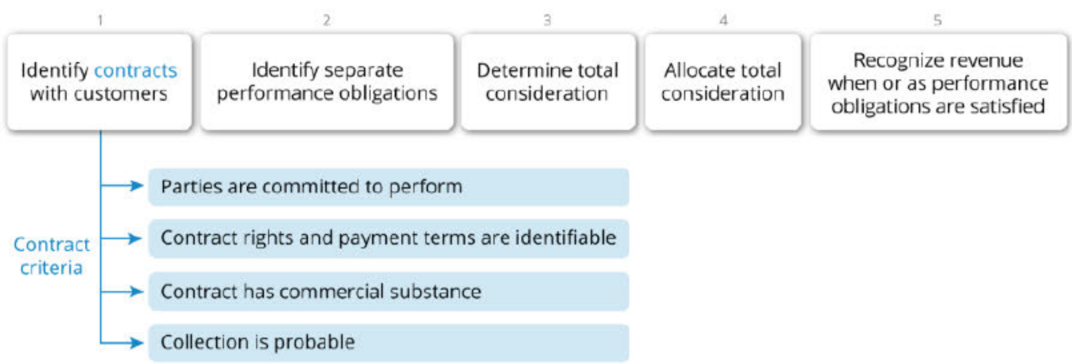
2.06 Collectibility of Receivables is Uncertain

5-Step revenue recognition process



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Collection Uncertainty

When a sale is made in exchange for a receivable, the entity must determine whether the receivable is likely to be collected.

Collection is Probable

If an entity determines that it is *probable* (ie, likely) that *substantially all* (generally about 90%) of a receivable will be collected, revenue will be recognized under the 5-step process. Keep in mind that even when collection is probable, an allowance for uncollectibility (ie, credit losses) will still be recorded.

Assume an entity has a contract to provide goods to a customer for $900. The goods cost $540. When the performance obligation was satisfied, $150 was received from the customer and a receivable was recorded for the remaining amount owed. However, the entity expects that 10% of the receivable will not be collected. The following journal entries would be made:

Accounts receivable (A/R)	750	
Cash	150	
Sales revenue		900
Cost of Goods Sold	540	
Inventory		540
Credit loss expense*	75	
Allowance for credit losses*		75

A/R less the allowance for credit losses is the amount expected to be collected, or Net Realizable Value (NRV).

These accounts may also be referred to as bad debt expense and allowance for doubtful accounts, respectively.

Assessing Probability of Collection

To determine the likelihood of payment, an entity should consider whether the customer has the ability and intent to pay for goods/services *expected to be transferred.* This means the entire duration of a contract doesn't necessarily need to be considered collectible in order for revenue to be recognized. That is, only amounts the entity expects to be entitled to for the transfer of goods/services must be collectible in order for those amounts to be recognized as revenue.

In some circumstances, the magnitude of uncertainty regarding collectability (ie, credit risk) can be significantly mitigated by the terms of the agreement.

- For example, if *payments are due prior to the provision of goods/services*, a contract would be considered collectible even if it is likely that the customer will default. This is because there is no risk that the entity will not be paid for goods/services provided.
- Credit risk would also be significantly diminished if the entity can *stop transferring goods/services* if the customer fails to pay amounts as they become due.

Note that an entity cannot consider the ability to repossess goods transferred as mitigation of credit risk.

Collection is Not Probable

There are numerous reasons an entity may sell to a customer when collection is not probable. For example:

- A sale could be at such a great margin that the initial payments plus the value of the merchandise that will be repossessed upon the customer's default still provides a profit to the seller.
- The seller may believe that a sale to a start-up business in a competitive environment could increase market share if the customer performs, making the risk worthwhile.

The *probability of collection*, however, is one of the four criteria that are required for the transaction to be considered a contract for revenue recognition purposes. So, if collection is highly uncertain and credit risk cannot be mitigated, revenue from the transaction would *not* be recognized under the 5-step process. The arrangement will be reevaluated every reporting period to determine whether it has met the criteria, at which time the 5-step process will apply.

Revenue Arrangements that are Not Contracts with Customers

As previously mentioned, when an entity enters into an arrangement that meets some of the contract criteria, but not all (eg, collection is not probable), revenue will be recognized in accordance with another approach, usually resulting in revenues being recognized later. Under this method:

- All receipts from the customer for the goods/services that are the subject of the arrangement are reported as a *liability*.
- The liability represents the entity's obligation to provide such goods/services or to refund the consideration received.

Assume the same facts as the last example, except the arrangement is not considered a contract for revenue recognition purposes (eg, because substantially all amounts due are not likely to be collected) and only a fourth of the goods, costing $135, have been provided. When the entity receives the $150, the following journal entries would be recorded:

Cash	150	
Unearned (deferred) revenue		150
Cost of goods sold	135	
Inventory		135

If the contract criteria are never met (eg, collection is never considered probable), the liability is *derecognized* and treated as *revenue* when *consideration* received from the customer is *nonrefundable and one of the following* scenarios applies:

Scenario 1	Scenario 2	Scenario 3
• The entity has no remaining obligations, and • All, or substantially all, of the consideration has been received.	• The arrangement has been *terminated*.	• Consideration received relates to *goods/services*, the control of which, has been *transferred*; and • The entity has stopped transferring goods/services, and neither has an obligation to, nor intends to, provide any additional goods/services.

In our example, let's say that the arrangement is terminated, all amounts paid are nonrefundable, and the entity will not be transferring the remaining goods (ie, Scenario 3). At this point, the revenue can be recognized since there are no remaining obligations:

Unearned revenue	150	
Revenue		150

Installment Sales Method (For TAX)

Prior to the introduction of the revenue recognition standard in ASC 606, when collectability of a receivable was uncertain and the amount to be collected was not readily determinable, the installment sales method was applied. While this method is no longer allowed under GAAP, it is still used for tax purposes (discussed later).

- Gross profit = Sales – COGS
- Gross profit % = Gross profit / Sales price
- Gross profit recognized for tax purposes = Cash collected × Gross profit %